

***United States Court of Appeals
for the Second Circuit***



AMICUS BRIEF

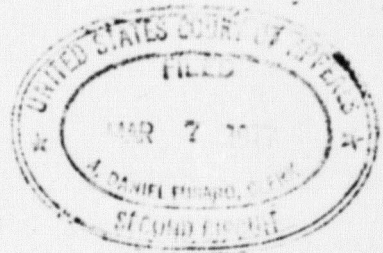
77-6005

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SECURITIES INVESTOR PROTECTION CORPORATION,)
Applicant,)
v.)
EXECUTIVE SECURITIES CORPORATION,)
Defendant.)
SECURITIES AND EXCHANGE COMMISSION,)
Plaintiff,)
v.)
EXECUTIVE SECURITIES CORPORATION, ET AL.,)
Defendants.)

Docket
No. 77-6005

On Appeal from the
United States District
Court for the Southern
District of New York



BRIEF OF COLUMBIA UNIVERSITY, AMICUS CURIAE

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	)	District of New York
Plaintiff,	)	
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EXECUTIVE SECURITIES CORPORATION, ET AL.,	)	
	)	
Defendants.	)	

BRIEF OF COLUMBIA UNIVERSITY, AMICUS CURIAE

PRELIMINARY STATEMENT

This brief is submitted by Columbia University ("Columbia") as amicus curiae in support of the position taken by Yale University ("Yale") on this appeal. Leave to file this brief on or before March 7, 1977 was granted February 25, 1977 by order of Judge E.A. Van Graafeiland of the United States Court of Appeals for the Second Circuit.

Columbia's interest in this appeal is twofold, and fairly illustrates the widespread concern over the issue before the Court. Columbia is currently involved as a claimant in bankruptcy proceedings against T.P. Richardson & Co. Inc. ("Richardson"). Richardson, a registered broker-dealer in securities, was adjudged bankrupt on July 8, 1975 by the United States District Court for the Central District of California upon the petition of Columbia, Yale and Bowery Savings Bank. Columbia had made loans of securities to Richardson under much the same arrangement -- fully cash collateralized, mark-to-market capability -- as that between Yale and Executive Securities Corporation ("Executive") underlying the current proceedings. The Securities Investor Protection Corporation ("SIPC") refused to intervene in connection with the Richardson proceedings, on the ground that institutions that do no more than lend securities to a broker-dealer are not "customers" for purposes of the Securities Investor Protection Act of 1970 ("SIPA"), 15 U.S.C.A. § 78aaa et seq. (1971).

The Securities and Exchange Commission ("SEC") has entered into an agreement with SIPC that the latter will be bound by the determination in the Executive case: i.e., if claimant-appellant Yale is determined to be a "customer" of the failed broker-dealer in the action here on appeal, SIPC

will take appropriate steps in connection with the Richardson proceedings which could afford to Columbia and others similarly situated the protection of SIPA.

The foregoing demonstrates Columbia's immediate interest in this appeal. However, Columbia has a further interest of potentially equal significance. As with many educational institutions maintaining active investment portfolios, Columbia's normal investment operations regularly include loan transactions of this nature. These transactions afford such institutions an alternative to selling securities they may not wish to sell; the lender obtains cash collateral to place in short term investments while the securities are available to the borrowing broker-dealer for completion of market transactions. Thus, the future participation of Columbia and similar institutional investors in this important segment of the market will be significantly affected by the decision in this appeal.

Columbia fully endorses and adopts the brief filed by Yale in this appeal, and in this amicus brief will address primarily points not raised by Yale and points deserving of additional emphasis.

ARGUMENT

- I. A CAREFUL AND INTERNALLY CONSISTENT READING OF THE STATUTE CONFIRMS SIPA COVERAGE FOR SECURITIES LOAN TRANSACTIONS NOT ASSOCIATED WITH A TRADING ACCOUNT OF THE LENDER WITH THE BORROWER, NOR WITH TRADING ACTIVITY OF THE LENDER THROUGH THE BORROWER.

- A. SIPA requires broker custody of the claimant's property, but does not require the claimant to have a trading account.

With all due respect, we submit that Judge Tenney and Judge Galgay in their opinions below have misread the plain language of the definition of "customer" in SIPA (in addition to misconstruing the import of this Court's decisions in SEC v. F.O. Baroff Co. and SIPC v. Morgan, Kennedy & Co., as will appear infra). Judge Galgay required that loans by customers be made "from accounts with the broker-dealer through which investment or trading in securities took place." SEC v. Executive Securities Corp., Opinion of Judge Galgay (S.D.N.Y 1976), reprinted in the Joint Appendix at 7a. Judge Tenney, with direct reference to the language of SIPA, read the definition of customers as being "clearly limited to persons who maintain accounts with broker-dealers and who trade or invest through them," and he would further restrict coverage of securities lenders to "customers who made loans . . . out of their trading accounts." SEC v. Executive

Securities Corp., 423 F. Supp. 94, 98 (S.D.N.Y. 1976), reprinted in the Joint Appendix at 18a. The exceedingly narrow definition this Court is asked to affirm -- as law -- bears no resemblance to the definition of customer enacted by Congress.

Section 6(c)(2)(A)(ii) of SIPA, 15 U.S.C.A.

§ 78fff(c)(2)(A)(ii), states in pertinent part: -

"customers" of a debtor means persons . . . who have claims on account of securities received, acquired, or held by the debtor from or for the account of such persons . . . (VI) by way of loans of securities by such persons to the debtor

(Emphasis added.) We submit that the emphasized portion should properly be read

from [such persons] or for the account of such persons, not, as Judge Tenney would arrange this critical phrase, from [the account of such persons] or for the account of such persons.

See 423 F. Supp. at 98 n.2, Joint Appendix at 20a.

Judge Tenney's arrangement of "from or for the account of" (which must have led, at least in part, to the overriding necessity of a trading account he perceived) would compel a meaningless reading of grammatically similar expressions elsewhere in SIPA. For example, section 6(c)(2)(B) ("single and separate fund") describes

property . . . received, acquired, or held by or for the account of a debtor from or for the account of customers

(Emphasis added.)

Arranged as Judge Tenney would presumably read it, part of this phrase would become "property received, acquired, or held by the account of the debtor." Receipt in an accounting sense -- i.e., receipt as a credit in favor of the broker-dealer -- is adequately covered by the phrase, "for the account of," without the need for a strained juxtaposition of "by" with "the account of," resulting in at best a redundancy. Receipt "by the debtor" in fact involves a separate concept -- i.e., physical possession, as does receipt "from the debtor." This two-concept interpretation of these disjunctive phrases is appropriate in light of the aim of SIPA to provide protection for customer property in the custody of the broker-dealer, whether initially by physical possession ("safekeeping") or entirely through accounting entry. See H. Rep. No. 1613, 91st Cong., 2d Sess. (1970), reprinted in 3 U.S. Code Cong. & Admin. News 5254, 5255-56 (1970).

Section 6(c)(2)(C) "(specifically identifiable property)" contains the same phrase -- "received, acquired, or held by or for the account of a debtor" -- as section 6(c)(2)(B). However, in subsection (ii) thereof, reference is made to "securities held for the account of the debtor"; and in subsection (iii) thereof, reference is made to "property held for the account of customers." (Emphasis added.) This further buttresses the illogic of a phrase such as

"held by the account of" and suggests the unlikelihood that the phrase "held from the account of " was meant to be employed here or elsewhere. Indeed, nowhere in SIPA does either of these unlikely phrases or their variants appear. Only by strained reading can they be made to appear.

Finally, section 6(d) ("Completion of open contractual commitments") contains the phrase, "paid or delivered by or for the account of such customer." Again, "paid or delivered by the account of such customer" is an awkward and unlikely concept, yet Judge Tenney's reading of "from or for the account of such [customers]" would suggest that interpretation.

We submit that the language of SIPA cannot properly be read, as Judge Tenney has read it, to command that persons must maintain a trading account with a broker-dealer in order to be considered his customer for purposes of SIPA coverage.

B. Trading activity with the borrower in connection with the loan of securities is not required under SIPA.

Sections 6(c)(2)(A)(i)(I) to (VI) describe six situations in which a broker-dealer may obtain custody of securities from persons or for their account and in which claims may subsequently arise. A person whose transaction with a broker-dealer is described by any of these situations,

and whose claim in connection therewith arises from retention of his securities in the custody of the broker-dealer, is, we submit, a customer of the broker-dealer under SIPA.

The situations described are (1) receipt (or acquisition or holding) for safekeeping, (2) receipt, etc. with a view towards sale, (3) receipt to cover consummated sales, (4) receipt pursuant to purchases, (5) receipt as collateral security, and (6) receipt by way of loans by the owner of the securities to the broker-dealer. Situations (2), (3) and (4) appear to cover the range of trading activity where the broker-dealer acts as agent of the customer. However, customers may also be persons with whom the broker-dealer deals as principal. This is the case where the broker-dealer borrows securities outside the context of trading activity carried on on behalf of the lender. In (6), such lending activity is explicitly recognized as a situation in which the customer relationship will arise for purposes of SIPA. A claimant may be a customer if he fulfills but one of the various combinations of transaction situations and types of custody. Claimant-appellant Yale's position as a lender of securities for consideration to broker-dealer Executive clearly places it within a well-defined category of customer: a person who has claims on

account of securities received, acquired or held by the debtor from such person by way of loans of securities by that person to the broker-dealer. SIPA § 6(c)(2)(A)(ii)(VI).

C. The courts below have placed a restrictive interpretation on the Baroff case unintended by this Court and unwarranted by SIPA.

Judge Galgay relied principally on this Court's opinion in SEC v. F.O. Baroff Co., 497 F.2d 280 (2d Cir. 1974) in holding that only those persons maintaining an investment or trading account with the borrowing broker-dealer would be considered his customer for purposes of SIPA protection. Judge Tenney agreed with this reading of Baroff.

Baroff does not support such a strained interpretation of SIPA and, we respectfully submit, nothing in this Court's Baroff decision should erect a barrier to the relief requested by appellants. This Court in Baroff disapproved SIPA coverage for a person who had become a creditor of the broker-dealer for reasons independent of and unassociated with the securities market. 497 F.2d at 283. Drawing upon the history of section 60e of the Chandler Act, however, this Court ascribed to SIPA the purpose of protection of those who have entrusted securities to a broker for some purpose connected with participation in the securities markets.

Id.

The 1970 Act carries through the same theme. The House Report states: "The primary purpose of the reported bill is to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." H. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970)

497 F. 2d at 283 (emphasis added).

On the facts before us [in Baroff], the loan had nothing at all to do with conventional investment, trading or participation in the securities market Because appellant's loan to the broker-debtor had no connection with his trading activity in the securities market, he cannot qualify by virtue thereof as a "customer" entitled to the benefits of [SIPA].

Id. at 284.

The securities loan transactions entered into by claimant-appellant Yale, and by Columbia and many other institutions as well, are entirely different from the gratuitous, non-"investment related" loan in Baroff. The former type of loan is not only related to the general investment activity of the institution -- and thus to its status as an "investor" -- it is, in economic fact, an investment of the securities directly in the securities market, the return being cash (at zero interest) facilitative of more traditional short-term investments, which then produce a yield. The securities market nexus of this type of loan is that it assists the broker-dealer in connection with its daily investment operations on behalf of other customers. The loans serve the securities

industry well by allowing completion of open transactions, thus avoiding the domino effect of one failure in a chain of incompleting transactions "that was one of the primary causes of the securities processing crises of the late 1960's and early 1970's." Letter of SEC Chairman Garrett to Internal Revenue Service (April 2, 1974), reprinted in Yale Brief at 39. These loans are clearly a well-recognized and important part of broker-dealer operations generally, and it is highly unlikely that Congress did not mean what it said when it employed language that would cover these types of transactions in the definition of customers under SIPA. See § 6(c)(2)(A)(11)(VI).

The courts below have misconstrued the unusual situation presented in Baroff, and in so doing have arrived at a strained interpretation of the prerequisites for customer status under SIPA. The distinction drawn between lenders who maintain trading accounts with the borrower and those who do not is without substance and arbitrarily restricts lending of securities regardless of mutual need or desire or purposes clearly related to the securities market. The broker-dealer with whom the securities owner does maintain an account may not have any need to borrow the particular issues in the owner's account. Conversely, a broker-dealer may find that none of his customers who maintain regular

accounts with him own the particular issue he needs to borrow. Yet the definition of customer applied below would deny SIPA protection to securities loan transactions unless there were a perfect match-up of broker-dealer needs with in-house resources. No reasonable support may be found -- without straining -- for the belief apparently held below that Congress intended to limit so narrowly a solution to the problem of uncompleted transactions in a climate of broker-dealer financial uncertainty, when indeed Congress's clear intent was to restore confidence in the market for securities and promote the financial responsibility of broker-dealers. Securities loan transactions between former strangers are part and parcel of the second goal, and such transactions are discouraged by the lower courts' hesitancy in achieving the first.

We submit that the loans made by claimant-appellant Yale to Executive are expressly contemplated by SIPA as transactions giving rise to customer status, that Baroff is not to the contrary, and that Yale is thus entitled to protection under SIPA.

- D. Applying other sections of SIPA in accordance with the remedial nature of the legislation would compel acceptance of Yale's status as customer.
-

Section 6(c)(2)(B) establishes a "single and

separate fund" to be maintained by the SIPA trustee. The fund shall consist of

[a]ll property at any time received, acquired, or held by or for the account of a debtor from or for the account of customers . . . and the proceeds of all customers' property transferred by the debtor

Id. Customers are to share in the fund on the basis of their net equities. Id.

A trustee collecting property for the single and separate fund, keeping in mind the remedial nature of SIPA, would have a duty to collect as much property "received . . . by or for the account of the debtor" as possible, both to satisfy customer claims and to reduce the net total of SIPC advances under § 6(f). He would thus be inclined to include securities loaned to the debtor totally apart from any trading accounts or activity, as well as loans from established accounts. The inclination would therefore be to read the phrase "from or for the account of customers" where that appears in the § 6(c)(2)(B) definition of single and separate fund, in accordance with the phrasing suggested by Yale so as to include securities received by the debtor from a non-trading account customer. Judge Tenney's interpretation of the critical phrase in the § 6(c)(2)(A)(ii) definition of customer would not permit this logical, remedial application of the single and separate fund provision.

Indeed, Judge Tenney has taken the one example of a grammatical expression well-used throughout SIPA that can be read as he reads it, and which reading finds some support in legislative history that does indeed indicate a desire to protect trading customers. However, non-trading customers -- whose securities were with the broker for safekeeping or in connection with loans -- were to be protected as well; and if Judge Tenney had tried to apply his interpretation of the critical phrase elsewhere that it appears, the difficulty would have been apparent. We respectfully submit that only Yale's interpretation can be applied consistently throughout SIPA and with the legislative history of that remedial statute.

II. COVERAGE OF THESE LOAN TRANSACTIONS DOES NOT RESULT IN A "BAILOUT."

Much reference has been made in the decisions below, in Baroff and in other cases arising under SIPA to the congressional testimony of then SEC Chairman Hamer Budge, in which he explains certain limits of then-proposed legislation containing a broker-dealer insurance provision not subsequently adopted in SIPA:

MR. BUDGE. We think that in addition to whatever its other legal responsibilities and liabilities may be, that the New York Stock Exchange has the responsibility to take complete charge of, to liquidate, and to reimburse

the public for any losses of its member firms which are now in a net capital deficiency or which may hereafter be in a net capital deficiency prior to the enactment of [SIPA].

MR. HARVEY. I certainly do agree with what you are saying. I think we should go at least that far.

MR. BUDGE. The Commission feels very strongly on this point that this is not to be a bailout operation; it is to protect the public customers of the firms, but recognizing that the exchanges have a responsibility in this area for any firms which have been doing business with the public when they were not within the net capital requirements.

Hearings on H.R. 13308 et al. Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 2d Sess. 369 (1970) (statement of Hamer H. Budge) (emphasis added).

It is clear, when the statement is thus read -- in its entirety -- that Chairman Budge was referring to the absence of a purpose to assist in those cases where the failure of the broker-dealer is due to a capital deficiency existing at the time the then-pending legislation would be enacted. Indeed, a colloquy immediately preceding the often-quoted "bailout" statement squarely confirms this reading:

MR. BUDGE. It is my understanding that at the time of the establishment of the Federal Deposit Insurance Corporation that some banks and savings and loans were not permitted to become members because of their financial condition at that time. It is our feeling in this

bill that it is necessary to insure the entire community, and we would not feel that it was in the public interest to remove the firms which might be in the same category as those banks and savings and loan that were not permitted to become members at the time.

MR. HARVEY. May I ask: is that in the public interest?

MR. BUDGE. The purpose of the legislation is to protect the customers of the brokerage houses, and if we take out the funds where the greatest exposure is we are removing the protection of all the customers of those firms. It isn't as easy to determine the financial condition of a brokerage house as it is a bank and savings and loan.

The only rationale by which that could be done that I can think of would be to exempt out firms which are not now in capital compliance. That would be, so far as we know, a small part of the community at the moment.

MR. HARVEY. Well, Mr. Chairman, if I might just ask a question.

MR. MOSS. The floor is yours and you may proceed to ask questions to your satisfaction.

MR. HARVEY. It certainly is not in the public interest for the Federal Government to have to bail out firms that are already bankrupt. By "bankrupt" I don't mean the formal bankruptcy, but I mean that are insolvent. Do you agree?

MR. BUDGE. I would assume the Government would pursue any such firm and recover whatever is recoverable. But the purpose of the legislation is not to bail out any firm. It is to protect the customers of that firm, and I think the New York Stock Exchange recognizes in the letter which has been submitted as an exhibit this morning that it is responsible as of this time for the firms who might not be in compliance with the capital requirements. Certainly the Commission would expect that that would be the least of the New York Stock

Exchange's responsibility.

Hearings on H.R. 13308 et al., supra, at 367-68 (emphasis added).

Judges Galgay and Tenney, and indeed this Court in Baroff, 497 F.2d at 283, we respectfully submit, have misread the intent and lost sight of the application and context of the "bailout" statement. Judges Galgay and Tenney have incorrectly found, on the basis of that misreading, an otherwise invisible Congressional purpose to constrict the coverage otherwise accorded investors by the express terms of SIPA. The clear language defining "customer" should control, not a notion as to relative dignities of transactions based on a reference to bailouts irrelevant to this discussion.

Indeed, Congress specifically addressed the problem of protecting the customers of a failed firm without serving as well the entrepreneurs behind the firm, by adding to SIPA's definition of customer the narrow caveat that

[customers] shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor

Section 6(c)(2)(A)(ii). Yale's loan transaction with Executive was hardly a contribution to capital. By written agreement, it was 100% cash collateralized, and thus was

intended to contribute nothing to Executive's capital. Unlike the loan in Baroff, Yale's loan has all the earmarks of an arm's-length transaction for full consideration and with a clear investment purpose.

III. DILIGENCE IN PROTECTING SECURITIES
HELD BY A BROKER-DEALER IS NOT A
QUALIFICATION FOR PROTECTION UNDER
SIPA.

Judge Tenney approved the view of Judge Galgay that Yale's loss relates to its failure to mark-to-market diligently under the loan agreement and insist upon sufficient additional cash collateral. SIPA does not exclude from its remedial provisions customers who might have followed a different course and averted part or the whole of a loss. Were this to be a requirement, then any customer who discounted reports or rumors of impending financial difficulty of a broker-dealer and proceeded to transact business with him would be denied protection. There is no support in SIPA or in its legislative history for any such result.

Indeed, it was acknowledged by Chairman Budge that the financial condition of a broker-dealer can change radically very quickly, making it much more difficult to predict than that of a bank. Hearings on H.R. 13308 et al., supra, at 368. If anything, arrangements by which customers and broker-dealers guard against loss from financial failure

strengthen the securities market, serve to buttress investor confidence, and are supportive of the central policy of SIPA to improve the financial responsibility of broker-dealers.

CONCLUSION

In summary, we submit that both the language and purpose of SIPA require rejection of Judges Tenney and Galgay's unnecessarily restrictive interpretation of the phrase "from or for the account of [customers]" in §6(c)(2)(A)(ii). The decision of Judge Tenney would subvert the intended application of SIPA, whereas SIPA is clearly served by its application to institutional investors who loan securities to one broker-dealer but trade through another. This Court's decision in Baroff is no bar to a decision of this appeal favorable to Yale. Finally, if diligence were at all relevant to coverage under SIPA, few if any participants in the securities market could ever rely on that remedial legislation.

For the foregoing reasons and those expressed in the brief of claimant-appellant Yale filed in this appeal, the judgment of the District Court upholding the determination of the Bankruptcy Judge should be reversed, and

the Bankruptcy Court ordered to allow the claim of Yale
as a customer under SIPA.

Respectfully submitted,

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The undersigned being duly sworn, deposes and says:

I am over the age of eighteen years, and on the 7th day of March, 1977, I served a true copy of the attached amicus brief by depositing a true copy thereof, enclosed in a post-paid wrapper, in an official depository under the exclusive care and custody of the United States Post Office Department, in the Borough of Manhattan, City and State of New York, addressed respectively to:

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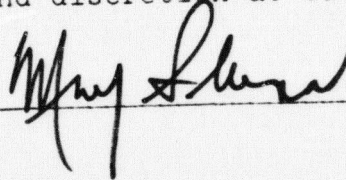
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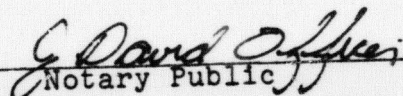
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to a person of suitable age and discretion at each.

Sworn to before me this 7th
day of March, 1977.




Notary Public

J. DAVID OFFICER
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No. 32000
Qualified in New York County
Commission Expires March 30, 1978

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